

Tax Management

Estates, Gifts and Trusts Journal

BNATAX
Management®
America's Tax Authority

Vol. 34, No. 3

May-June

May 14, 2009

ARTICLES

- 139 Federal Tax Treatment of “Ponzi Scheme” Theft Losses**
by David F. Earley
- 148 Bill Would Have Far-Reaching Effect on Gift and Estate Tax Valuation**
by Jonathan Blattmachr, Esq., and Scott Nammacher
- 150 The Intersection of Income in Respect of a Decedent, the Separate Share Rule and Making Charitable Bequests — Be Sure to Look All Ways Before Crossing**
by Marc S. Bekerman, Esq.

LEADING PRACTITIONER COMMENTARY

- 156 FLPs — Estate Inclusion of Partnership Interests Under §2036**
by Kathleen Ford Bay, Esq.
- 158 Service Rules Favorably on Private Split-Dollar Insurance**
by Beverly R. Budin, Esq.

TRENDS AND TECHNIQUES

- 160 Tax Court Finds Ambiguity in Tax Clause and Applies State Apportionment Statute**
- 160 Ninth Circuit Affirms 5% Discount for Partial Interest in Art**
- 160 IRS Recognizes Impact of Proposed Reformation to Correct Power of Appointment**
- 161 Regulations if Decedent Was in Combat Zone or Federally Declared Disaster Zone**

TAX MANAGEMENT ADVISORY BOARD ESTATES, GIFTS, AND TRUSTS

Leonard L. Silverstein, Esq., *Chairman; Gerald H. Sherman, Esq., Deputy Chairman*
Buchanan Ingersoll & Rooney PC, Washington, D.C.

Byrle M. Abbin, CPA
WTAS, LLC
McLean, Virginia

Robert Anthoine, Esq.
Pillsbury Winthrop Shaw
Pittman LLP
New York City

Ronald D. Aucutt, Esq.
McGuireWoods LLP
McLean, Virginia

Kathleen Ford Bay, Esq.
Potts & Reilly LLP
Austin, Texas

Dennis I. Belcher, Esq.
McGuireWoods LLP
Richmond, Virginia

Lawrence Brody, Esq.
Bryan, Cave, LLP
St. Louis, Missouri

Beverly R. Budin, Esq.
Ballard Spahr Andrews
& Ingersoll, LLP
Philadelphia, Pennsylvania

Christopher P. Cline, Esq.
Wells Fargo Private Bank
Portland, Oregon

Richard B. Covey, Esq.
Carter, Ledyard & Milburn
New York City

Prof. Robert T. Danforth
Washington and Lee
University School
of Law
Lexington, Virginia

Julia B. Fisher, Esq.
JPMorgan Private Bank
Philadelphia, Pennsylvania

Alan S. Halperin, Esq.
Paul, Weiss, Rifkind,
Wharton & Garrison LLP
New York City

David A. Handler, Esq.
Kirkland & Ellis
Chicago, Illinois

T. Randolph Harris, Esq.
McLaughlin & Stern, LLP
New York City

Michael A. Heimos, Esq.
Mullin Dean & Heimos LLC
Denver, Colorado

Jerome M. Hesch, Esq.
Miami, Florida

Linda B. Hirschson, Esq.
Greenberg Traurig, LLP
New York City

H. Carter Hood, Esq.
Ivins, Phillips & Barker,
Chartered
Washington, D.C.

L. Paul Hood, Jr., Esq.
(A Professional Law Corporation)
Mandeville, Louisiana

Richard M. Horwood, Esq.
Horwood, Marcus & Berk
Chicago, Illinois

John B. Huffaker, Esq.
Pepper, Hamilton & Scheetz
Berwyn, Pennsylvania

**Prof. Daniel C.
Knickerbocker, Jr.**
Brooklyn, New York

Donald D. Kozusko, Esq.
Kozusko Harris Vetter Waher LLP
Washington, D.C.

Johannes R. Krahmer, Esq.
Morris, Nichols, Arshat Tunnell
Wilmington, Delaware

Jerry J. McCoy, Esq.
Washington, D.C.

Malcolm A. Moore, Esq.
Davis Wright & Tremaine
Seattle, Washington

Michael D. Mulligan, Esq.
Lewis, Rice & Fingersh, L.C.
St. Louis, Missouri

Terence S. Nunan, Esq.
Rutter Hobbs & Davidoff, Inc.
Los Angeles, California

Anne J. O'Brien, Esq.
Arnold & Porter
Washington, D.C.

Lynn K. Pearle, Esq.
Arent Fox, LLP
Washington, D.C.

Prof. Jeffrey N. Pennell
Emory University
School of Law
Atlanta, Georgia

Lloyd Leva Plaine, Esq.
Sutherland
Washington, D.C.

Nora E. Pomerantz, Esq.
Duane Morris LLP
Philadelphia, Pennsylvania

Susan P. Porter, Esq.
United States Trust Company
New York City

Laurence Reich, Esq.
McElroy, Deutsch, Mulvaney
& Carpenter, LLP
Newark, New Jersey

Howard D. Rosen, Esq.
Donlevy-Rosen & Rosen
Coral Gables, Florida

Gideon Rothschild, Esq.
Moses & Singer, LLP
New York City

Donald Schapiro, Esq.
Chadbourne & Parke LLP
New York City

Keith Schiller, Esq.
Schiller Law Group
Orinda, California

Pam H. Schneider, Esq.
Gadsden Schneider
& Woodward, LLP
King of Prussia, Pennsylvania

James S. Sligar, Esq.
Milbank, Tweed, Hadley & McCloy
New York City

Prof. William P. Streng
University of Houston Law Center
Houston, Texas

John A. Wallace, Esq.
King & Spalding
Atlanta, Georgia

Aen Walker Webster, Esq.
Buchanan Ingersoll & Rooney PC
Washington, D.C.

Edward L. Weidenfeld, Esq.
The Weidenfeld Law Firm, P.C.
Washington, D.C.

Harry E. White, Jr., Esq.
Milbank, Tweed, Hadley & McCloy
New York City

Jeffrey Zaluda, Esq.
Horwood, Marcus
& Berk
Chicago, Illinois

Howard M. Zaritsky, Esq.
Rapidan, Virginia

TAX MANAGEMENT

Gregory C. McCaffery, *President*
Darren McKewen, *Group Publisher*
Glenn B. Davis, Esq., *Executive Editor*
Harold W. Pskowski, Esq., *Managing Editor*

BUCHANAN INGERSOLL & ROONEY PC

Aen Walker Webster, Esq., *Chairman*
Beverly R. Budin, Esq., Kathleen Ford Bay, Esq.
and Steven B. Gorin, Esq., *Contributors*



Tax Management Estates, Gifts and Trusts Journal (ISSN 0886-3547) is published bimonthly, at the annual subscription rate of \$470 for a single print copy, by The Bureau of National Affairs, Inc., 1801 South Bell St., Arlington, VA 22202. **Periodicals Postage Paid** at Arlington, VA and at additional mailing offices. **POSTMASTER:** Send address changes to Tax Management Estates, Gifts and Trusts Journal, BNA Customer Service, 9435 Key West Ave, Rockville, MD 20850.

Copyright Policy: Reproduction of this publication by any means, including facsimile transmission, without the express permission of Tax Management Inc. is prohibited except as follows: 1) Subscribers who have registered with the Copyright Clearance Center and who pay the \$1.00 per page per copy fee may reproduce portions of this publication, but not entire issues. The Copyright Clearance Center is located at 222 Rosewood Dr., Danvers, MA 01923. Tel. (508) 750-8400; 2) Permission to reproduce Tax Management material otherwise can be obtained by calling (703) 341-5884. Fax (703) 341-1624.

Copyright © 2009 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc., Arlington, VA 22202, U.S.A.

ARTICLES

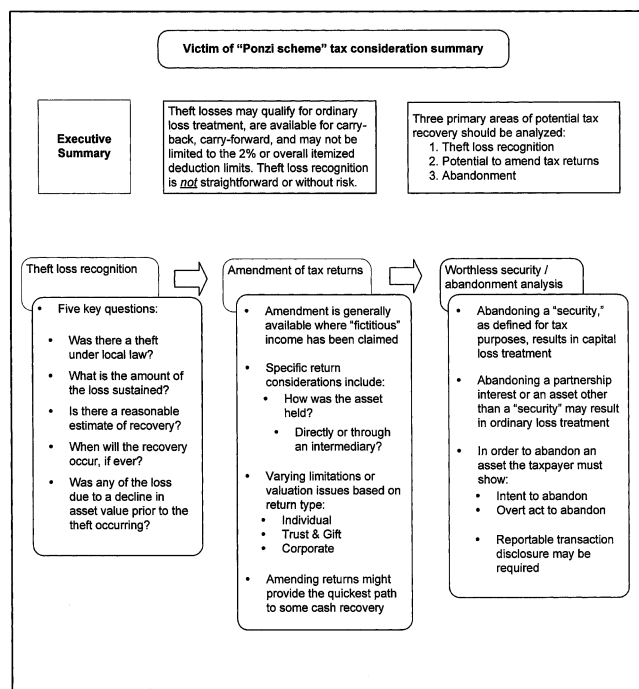
Federal Tax Treatment of “Ponzi Scheme” Theft Losses

by David F. Earley
Deloitte Tax, LLP
Boston, MA*

INTRODUCTION

The 2008 investing year is finally over, but it will not soon be forgotten. The S&P 500 Index opened on January 2, 2008, at 1,467.97 and closed on December 31, 2008, at 903.25, posting over a 38% loss in value. The year 2008 also may have handed investors one of the largest frauds committed in the history of the financial markets. These are certainly not small challenges for investors to overcome; however, one unlikely source of reprieve for U.S. taxable investors may lie in the Internal Revenue Code. Investors that suspect they have been involved in a fraudulent investment should be aware of how specific details can impact their personal tax situation. In many fraud cases, complete facts can be elusive; this stands to frustrate the tax process, as appropriate action is fact and circumstance specific. Many investors will face loose ends and uncertainty in the face of imperfect information; this does not make the tax reporting process easy. The goal of this summary paper is to provide a framework of options for investors embroiled in fraudulent investment schemes, many of whom will struggle with potential decisions based on circumstances yet to be determined.

The “Ponzi Scheme” is one classic type of pyramid sham, and some unfortunate investors in 2008 may be faced with the reality that they funded one of the world’s largest. In a classic Ponzi scheme, investors are supplied with higher than normal, yet fictional, rates of return on their investment. These high returns entice additional investment dollars into the scheme. In the early stages of the scheme, if an investor chooses to withdraw some or all of an investment, the redemption request is honored. The scheme “Managers” may even go so far as to pay a small profits dividend; the net result of this redemption activity is to further legitimize the investment in the eyes of the investor and other potential targets. Invariably, the published rates of return are falsehoods, redemption activity is funded by subsequent contributions, investment dollars are absconded with, and ultimately the structure collapses inward when redemption requests exceed new investment proceeds. Unfortunately, in most cases, by the time the impropriety is discovered, it is too late to recover anything more than a fractional share of the total invested assets.



* Copyright © 2009 Deloitte Development LLC. All rights reserved. Comments on early drafts were received from James Calvin, Partner, Deloitte Tax LLP; Julie Canty, Partner, Deloitte Tax LLP; Laura Peebles, Director, Deloitte Tax LLP; Mark Schneider, Partner, Deloitte Tax LLP; Laura Berard, Manager, Deloitte Tax LLP; Bill O’Shea, Director, Deloitte Tax, LLP; John Keenan, Director, Deloitte Tax LLP; and Clint Stretch, Principal, Deloitte Tax, LLP. Any errors in the final version are the responsibility of the author.

NOTICE TO SUBSCRIBERS:

Because tax and legal matters are frequently subject to differing opinions and points of view, signed articles contained in the Journal express the opinions and views of the authors and not necessarily those of Tax Management or its editors. Other information and suggestions contained in the Journal should be independently examined before action is taken on the basis of such information since many of the items discussed are subject to change or may have different applications depending on local law.

From a tax perspective, an investor suffering a loss as a result of theft will generally have options to recognize a tax benefit that are not available under a non-fraudulent loss. Although a theft loss claimant may have more options for recognition of the loss, one key control element that may be lost relates to the timing of the loss. Under non-fraudulent circumstances, when an investor loses money in a financial instrument, the investor is generally able to determine the timing of recognition of the loss. Subject to anti-abuse rules such as §1091¹ losses from wash sales, §1092 straddles, and subject to method of accounting requirements such as §475 mark-to-market accounting methods, if an investor decides to liquidate a loss position he will realize a loss for tax purposes in the tax year of liquidation. Where a loss from theft is determined, the taxpayer will recognize the loss, to the extent ascertainable, in the taxable year in which such loss is discovered.² Nonetheless, timing differences aside, recognition of loss involving theft may grant a taxpayer additional options not available in typical capital loss transactions.

A typical loss, which is non-§1256 or another marked-to-market variant, related to an investment in a security will result in capital loss treatment. However, a loss involving a theft related to an investment transaction could give the taxpayer several different loss recognition options. Three potential options, which are the primary subject of this paper, include:

- I. Theft loss recognition
- II. Amendment of prior year open returns
- III. Worthless security recognition / abandonment of partnership interest

THEFT LOSS RECOGNITION

Section 165(a) allows deductions for any losses sustained that are not compensated for by insurance or otherwise. Section 165(c) limits the losses of individuals to losses incurred in either a trade or business, losses incurred in any transaction entered into for profit, or losses of certain personal property if from casualty or theft. Section 165(e) allows for the deduction of losses related to theft and provides that such losses shall be treated as being sustained during the taxable year in which the loss is discovered. Unlike capital losses, which come with limitations for both corporations and individuals,³ theft losses are granted

ordinary loss treatment⁴ and are not subject to the 2% or 80% itemized deduction limitations.⁵ In addition, while not free from doubt, a theft loss attributed to investing in a Ponzi scheme may not be subject to the 10% adjusted gross income limitations of §165(c)(3). If there is a silver lining for a taxable investor with substantial losses from a Ponzi scheme investment, it might just be treatment as a loss from theft.

An investor who loses money in a fraudulent scheme should qualify as having incurred losses in a transaction entered into for profit;⁶ however, in order to qualify for theft loss treatment, the investor must also answer the following questions:

- Did a “theft” occur under local law?
- What was the total amount of the loss sustained?
- How much, if any, might reasonably be recovered through SIPC insurance, through related lawsuits and other proceedings, or from the fund directly?
- When might recoverable amounts actually be recovered?
- Was part of the loss due to a bona fide decline in the value of investments?

Courts have repeatedly accepted Ponzi schemes as theft losses within the meaning of §165(e).⁷ Victims of frauds discovered in 2008 may need to wait for more facts to become available to make a determination of theft, but there does not need to be a prosecution prior to an investor claiming the deduction.⁸ The Regulations under §165 provide for a definition of “theft”;⁹ however, the courts have stated that whether a theft loss occurs depends upon the law of the jurisdiction where it was sustained.¹⁰

Often times a fund investment is multi-tiered, with fund operators accepting investments directly from individuals and corporations, as well as through “feeder” hedge funds and fund of funds operating in partnership form. For direct investors in a fraud, the determination of theft could be straightforward, that is, these persons invested directly in a fund based on false or misleading financial information provided to them directly by the fund manager. In cases where investors funded intermediaries that in turn provided in-

⁴ §165(h)(2).

⁵ §§67(b)(3) & 68(c)(3).

⁶ §165(c)(3) provides additional limitations for individuals in certain cases.

⁷ *Jensen v. Comr.*, T.C. Memo 1993-393 and *Berardo v. Comr.*, T.C. Memo 1987-433.

⁸ *Monteleone v. Comr.*, 34 T.C. 688 (1960).

⁹ 26 CFR §1.165-8(d).

¹⁰ *Edwards v. Bromberg*, 232 F.2d 107 (5th Cir. 1956).

¹ References to section, at times designated by the “§” symbol, refer to 26 U.S.C. — Internal Revenue Code.

² §165(e).

³ §§1211 & 1212.

vestment funds to the fraudulent fund, the determination of who incurred a theft could be more difficult. In cases involving intermediaries, there are two possible scenarios: (1) the intermediary partnerships were fraudulently induced into investment, or (2) the individual investors of the intermediaries were fraudulently induced into investment by complicit general partners of the intermediaries.

Although the two scenarios may have different legal implications, there will, in all likelihood, be little difference from a tax perspective. In the early 1990s, a large Ponzi scheme was uncovered in Florida that involved thousands of investors spread across multiple jurisdictions. The IRS faced inconsistent taxpayer treatment of these losses, and during the course of auditing the investments, issued two field service advice memoranda (FSAs).¹¹ At issue was whether the loss should be accounted for at the partner or the partnership level, given that it was currently unknown whether the general partner of the partnership had participated in the fraud.¹² If the loss were to be accounted for at the partnership level, the so-called TEFRA partnership audit provisions would apply and the IRS could focus resources at the intermediary level.¹³ If, however, the losses were to be accounted for at the individual level, the IRS was concerned that the statute of limitations would expire and thus the opportunity to contest deductions would be lost.

The IRS was considering issuing protective statutory notices of deficiency to each investor in order to preserve the ability to contest the timing and character of deductions. Ultimately, the IRS was comfortable having the partnerships issue valid statute of limitation extensions, as it was decided that a loss would be determined at the partnership level, regardless of whether the general partner was the victim of fraud or complicit in the scheme. The IRS reasoned that if the alleged theft victimized the partnership, and the general partner acted in his capacity as partner, then clearly this was a partnership-level loss. Furthermore, under the Revised Uniform Limited Partnership Act, a general partner that commits fraud is deemed as not acting in its capacity as a partner, and the partnership is entitled to deduct the loss as if a non-partner had committed the embezzlement.¹⁴ As such, under either of the two scenarios, the treatment of the

loss as a theft loss should be accounted for at the partnership level. In any event, taxable investors in feeder funds that in turn invest in a fraudulent fund have a significant vested interest in how the feeder fund manager reports the loss. The proper treatment of losses at the feeder fund level (i.e., capital vs. ordinary) could result in a tax benefit differential of as much as 20%.

The amount of the loss sustained might seem simple at first blush; however, in the flow-through context, this determination becomes less clear. For investors to calculate the amount of their loss in dollar terms (as a percentage it very well might be 100%), they will first need to determine their adjusted cost basis. Within a partnership structure, partners receive increases in basis for their contributions¹⁵ as well as for their distributive share of taxable income.¹⁶ Investors pay tax currently on distributive share income even if no cash is received from the investment. In many cases a Ponzi scheme presents a double whammy: the principal investment amount is lost, and, where taxable distributive share allocations are made, cash tax payments have been remitted based on fraudulent performance gains. The longer a Ponzi operation runs without detection, the greater the potential tax cost outlay will be.

Dramatically disparate tax treatment could occur depending on how fund performance is reported to investors, and ultimately on how feeder funds report losses to investors. In a case where an operation has been running for decades with new investors accepted on a continuous basis, there could be a significant disparity in the treatment of taxable U.S. investors. Given the differential in capital gain and ordinary tax rates, and given that theft losses receive ordinary treatment, although not free from doubt, it is conceivable that a taxable investor that lost everything could come out ahead after tax on a nominal basis.

Consider a scenario where an investor contributed 15 years ago to a feeder hedge fund invested exclusively in what turns out to be a fraudulent fund, identified as such during 2008 and recognized as a theft in the relevant jurisdiction. Assume additionally that the investor has never redeemed any funds and has been reported long-term capital gains each year on his Schedule K-1.

Assuming a \$1 million dollar initial capital contribution and a 12% annual compounded growth rate, and factoring in historic long-term capital gain rates for a taxpayer in the top marginal tax bracket, an investor of 15 years would chart the growth and tax basis of the investment as follows (ignoring time value considerations):

¹¹ FSAs are issued by the IRS National Office to respond to requests for guidance from IRS field personnel. FSAs provide non-binding advice to IRS staff and do not set precedent or establish uniform IRS treatment of positions.

¹² See 1994 FSA Lexis 555, June 3, 1994, and 1997 FSA Lexis 319, June 3, 1997.

¹³ Tax Equity and Fiscal Responsibility Act of 1982, see §§6221-6234.

¹⁴ See 1997 FSA Lexis 319, June 3, 1997.

¹⁵ See §722, or in the case of a transfer of interest, §742.

¹⁶ See §705, also see §703.

Year	BOY Capital Account	% Return	EOY Capital Account	LTCG	LTCG tax rate	LTCG taxes paid
1993	1,000,000	12%	1,120,000	120,000	28%	33,600
1994	1,120,000	12%	1,254,400	134,400	28%	37,632
1995	1,254,400	12%	1,404,928	150,528	28%	42,148
1996	1,404,928	12%	1,573,519	168,591	28%	47,206
1997	1,573,519	12%	1,762,342	188,822	28%	52,870
1998	1,762,342	12%	1,973,823	211,481	28%	59,215
1999	1,973,823	12%	2,210,681	236,859	20%	47,372
2000	2,210,681	12%	2,475,963	265,282	20%	53,056
2001	2,475,963	12%	2,773,079	297,116	20%	59,423
2002	2,773,079	12%	3,105,848	332,769	20%	66,554
2003	3,105,848	12%	3,478,550	372,702	20%	74,540
2004	3,478,550	12%	3,895,976	417,426	15%	62,614
2005	3,895,976	12%	4,363,493	467,517	15%	70,128
2006	4,363,493	12%	4,887,112	523,619	15%	78,543
2007	4,887,112	12%	5,473,566	586,453	15%	87,968
2008	5,473,566	-100%	-0-			872,868

Going into 2008, the investor would show a beginning capital account balance of \$5,473,566 and would have paid cumulative long-term capital gain taxes of \$872,868. If in 2008 the investor qualifies for a 100% theft loss deduction, and is currently in the highest marginal tax bracket of 35%, the investor would receive a total tax benefit of \$1,915,748 ($\$5,473,566 \times 35\%$). Under this extreme example, the investor has written checks for \$1,872,868 (\$1 million to the fraud and \$872,868 to the IRS) and has received a total tax benefit of \$1,915,748.

It is not clear how the IRS, or Congress for that matter, would view such an accounting; but as details of 2008 frauds continue to emerge, there will undoubtedly be a few surprises. Although Ponzi schemes are probably not known for their reporting accuracy, and are actually incentivized to report not only attractive rates of return but also favorable tax treatment of those returns, the above example may remain hypothetical only. If the fact pattern regarding investment return were the same, but the investor had been receiving allocations of short-term capital gain and other ordinary tax rate items, there would be no rate arbitrage to benefit the investor.¹⁷ Congress is aware that varying tax rates based on asset classification can result in net rate benefit to taxpayers; and in some instances, such as depreciation recapture under

¹⁷ This does not consider potential state tax rate arbitrage. For instance, an arbitrage would exist if a significant percentage of gain comes from treasury bill interest, which is taxed federally, but not at the state level, and there is no offsetting adjusted basis reduction at the state level.

§1245 and §1250, has enacted legislation to equalize the impact on tax revenue. Feeder fund managers, as well as feeder fund investors, should also be aware that certain loss transactions may be required to be disclosed as a “reportable transaction” (see below for additional information).

Theft loss deductions under §165(e) have provided for a number of court opinions that can be looked to for guidance when determining appropriate tax treatment. One case potentially providing support for an ordinary deduction of adjusted partnership basis is *Pinson v. Comr.*¹⁸ In this case, the taxpayer tried to deduct as a theft loss payments from a partnership that should have been paid but were not due to theft. In the *Pinson* opinion the tax court states “. . . we must decide whether a cash basis taxpayer is entitled to a theft loss deduction for allegedly embezzled income, the answer depends upon whether the taxpayer reported the allegedly embezzled funds and paid tax on them. If the taxpayer has not, no sophisticated analysis is necessary to reach the conclusion that no deduction is allowed.” Based on this finding, it would seem reasonable that if a taxpayer has reported income from a partnership then the taxpayer’s basis should be increased and accounted for as part of the loss.

As is often the case in analyzing a tax position, however, other available information may cast a potentially opposing and negative light on the prospec-

¹⁸ T.C. Memo 1990-234.

tive deduction. In *Kaplan v. U.S.*,¹⁹ a taxpayer invested almost \$6 million into what turned out to be a Ponzi scheme involving over 800 investors and almost \$600 million of “investments.” Between 1992 and 1999, the investor reported having received \$4,136,433 in income and having paid \$1,125,967 in federal taxes. From 1992 to 1998, the tax rate on long-term capital gains was 28%; and in 1999, the tax rate on long-term capital gains was 20%.²⁰ During this period the taxpayer paid an average tax rate of 27.22% on the income, which would indicate that the majority of income received was in the form of long-term capital gains. The taxpayers first became aware of the potential fraud in late 2000 and on their 2001 income tax return claimed a theft loss deduction for the combined amount of their initial investment, their investment earnings, and, interestingly, the taxes paid on their investment earnings. The IRS asked the court to summarily dismiss the case, arguing: (1) the taxpayers did not prove they would not recover the funds, (2) a theft loss cannot be claimed for income allegedly earned, and (3) a theft loss cannot be claimed for taxes paid because the tax payments did not constitute a theft. The court ruled in favor of the IRS on all three points.

As with any technical argument, the specific facts of the case are crucial to understanding the final opinion. Not explained in the case background is the structure of the investment; for instance, did the taxpayer receive a partnership interest, did they fund some type of brokerage account, or was there some other more exotic type of arrangement? In this instance, although we are left with imperfect information, we may be able to glean some key points from the decision. Prior to the final decision in *Kaplan*, the IRS allowed the taxpayer to amend open year returns, thereby removing the previously claimed “phantom” capital gain income and receiving a refund of capital gain taxes paid. Arguing point one above, the IRS challenged the deduction of the theft loss by claiming that the taxpayer did not “show that it was reasonably certain as of December 31, 2001 [sic] that there was no reasonable prospect of recovering . . . funds.” On this point, the court reiterates the compelling case set forth by the IRS. The fact that the taxpayers decided to deduct the entire amount lost as a theft with no regard for ongoing litigation or reports of asset listings from the bankruptcy trustee probably did not help their cause. The key lesson on timing of a theft deduction, which in many cases might provide the most compelling evi-

dence against taking the deduction, is for the taxpayer to make sure that they either have a solid basis for taking a portion of the loss as a theft, or they can prove that fixed and determinable events have transpired that show with reasonable certainty that no recovery will occur.

On the issue of phantom income, or rather, income reported that increased the basis of the taxpayer’s investment in the fraud, the court’s findings were in lockstep with the IRS. In this case the taxpayer had reported and paid tax on income in years where the statute of limitations had expired. The IRS argued, and the court agreed, that the taxpayers did not provide sufficient proof that the income ever existed; therefore, they were incapable of proving there was a theft. Section 1311, which is discussed in more detail below, might have been available to provide relief in this situation, but the decision does not mention this. On this point in particular, it would be beneficial to have a complete set of facts as on its face this decision seems inequitable and possibly inconsistent with both §165 as well as other highlighted court decisions. Speculating on the causation of court decisions can be dangerous, but taxpayers arguing overly aggressive tax positions are probably not looked upon favorably. In this case, there is indication that the taxpayer’s initial claim of invested amount and reported investment return was higher than the ultimate facts proved — both of these items would grant a more favorable tax deduction to the taxpayer, to the detriment of the IRS. The taxpayer also claimed actual taxes paid as a theft loss, which is inconsistent with the taxpayer’s claim of theft loss on their increased adjusted basis. To this point, the court reasoned: “. . . the payment of income taxes on the income, while unnecessary, did not constitute an unlawful taking by the IRS. Without an unlawful taking, there can be no theft loss deduction for the taxes paid on the phantom income.”

As highlighted in the *Kaplan* case, theft deductions that straddle the statute of limitations can produce some eyebrow-raising results. In another case, a theft loss discovered in 1965, yet spanning multiple earlier years, presented additional complexities. The final result in this case, however, was decided favorably for the taxpayer. In *B.C. Cook & Sons, Inc. v. Comr.*,²¹ the taxpayer suffered a theft loss when an employee embezzled from the company and concealed the missing funds by inflating cost of goods sold. The employee accomplished this by creating sham companies, and then fraudulently issued payments to the companies for raw materials. As the inventory turned, the taxpayer claimed deductions for the as-yet-unknown embezzled amounts. After the statute of limitations had

¹⁹ 2007 U.S. Dist. LEXIS 59684 (M.D. Fla. 2007).

²⁰ These rates assume the taxpayer was in the top marginal tax bracket for each year. From July 29, 1997, through July 21, 1998, the 28% rate applied to investments held for 12-18 months. For this hypothetical scenario, the 28% rate is assumed for 1998.

²¹ 59 T.C. 516 (1972). See also *B.C. Cook & Sons, Inc. v. Comr.*, 65 T.C. 422 (T.C. 1975), *affd.* 584 F.2d 53 (5th Cir. 1978).

closed on the tax years to which the embezzled amounts were deducted, the taxpayer discovered the theft. Under §165(e), theft losses are sustained when discovered — the taxpayer claimed a theft loss and was allowed this loss by the Tax Court, giving the taxpayer a double deduction for the same loss. The IRS, citing the consistency doctrine, announced it would not follow the decisions of the Tax Court or the U.S. Court of Appeals in relation to this series of cases.²² As with the *Kaplan* case, the *B.C. Cook* case provides an inequitable result, which has been highlighted in other decisions.²³ Given the events of the 2008 calendar year, it would not be surprising if these inconsistencies are litigated to final resolution over the upcoming years.

Under §165, any amounts recoverable are not deductible as theft losses. The taxpayer will not be allowed a deduction for amounts covered by insurance, whether or not the taxpayer pursues the insurance claim, and amounts for which there is a “reasonable” chance of recovery. High-profile frauds are likely to be expedited from a liquidation standpoint; however, if pending litigation lingers, this may call into question the amount that ultimately could be recoverable. The determination of what constitutes a reasonable chance of recovery is based on the specific facts and circumstances of each situation that are known at the end of the tax year for which the deduction is claimed; additionally, the burden of proof is on the taxpayer to substantiate these amounts.

As highlighted in the *Kaplan* case above, the IRS has effectively argued against the taxpayer’s ability to claim theft losses on the basis that the taxpayer is unable to prove that the deduction does not have a reasonable chance of recovery. To claim a valid theft loss, an investor involved in a fraud will need to prove that no reasonable chance of recovery exists for the amount claimed as a deduction. The taxpayer’s desire to claim a loss as a theft is diametrically opposed to the taxpayer’s attempt to do everything in their power to try to recover her loss from the fraudsters. In fact, the harder and longer the taxpayer works at recovering their loss, the more she potentially makes the case for not taking a theft deduction. Taxpayers potentially build a case against themselves as their lawsuits wind through the courts, the trustees list and schedule assets for sale, and additional asset searches are conducted.

In the case of lower-tier feeder funds, where an investor has received a partnership interest in exchange for his investment, the reasonable determination of re-

covery could be even more difficult. Ponzi schemes involving partnerships may involve legal pursuit of not only the general partner or managing member, but also the limited partners based on the timing of payments from the fund.²⁴ Under U.S. bankruptcy laws, successful fraudulent conveyance claims may allow a bankruptcy trustee to void certain transfers made or incurred before the date of the bankruptcy filing. Pursuit of these claims could involve multiple financial institutions in various jurisdictions, leading to protracted time frames and uncertain outcomes. While the courts have stated taxpayers need not be “incorrigible optimists” when considering recoverable amounts, they have also stated that “if a taxpayer’s prospect of recovery was simply unknowable at the end of the year at issue, then the taxpayer will not be entitled to take the theft loss deduction that year.”²⁵

Investors may need to wait for additional facts to emerge to determine whether their investment holdings decreased as a result of deteriorating business conditions, theft, or both. If the answer is both, it will be necessary to determine at exactly what point the change occurred, as that demarcation will establish capital loss treatment versus ordinary theft loss treatment.²⁶ Based on the scale of the losses involved in any given situation, it would be welcomed for the IRS to issue specific advice, similar to the advice related to casualty losses issued after Hurricane Katrina, in order to guide taxpayers with their reporting requirements.

AMENDMENT OF PRIOR YEAR OPEN RETURNS

For individual and corporate taxpayers, the ability to amend prior year open returns, usually for the prior three years, might be an option if it is determined that taxable income amounts claimed were fictitious.²⁷ One note of caution here, based on existing IRS guidance, to the extent that distributions have been received in cash, they cannot be considered fictitious, or “phantom,” for this purpose.²⁸ For partnership filers the ability exists to amend prior year returns, but the process is more cumbersome.

For amended partnership procedures, Form 8082 is used. Form 8082 is also used in the case of individual

²⁴ See 362 B.R. 624 (2007), *Bayou Group, LLC & Bayou Superfund, LLC v. WAM Long/Short II, LP*.

²⁵ See *Ramsay Scarlett & Co. v. Comr.*, 61 T.C. 795 (T.C. 1974), and *Wagner v. U.S.*, 2003 U.S. Dist. LEXIS 2122 (M.D. Fla. 2003).

²⁶ See CCA 2008110016.

²⁷ See *Taylor v. U.S.*, 81 AFTR2d 98-1683, 98-1 USTC ¶50,354 (E.D. Tenn. 1998).

²⁸ See CCA 2008110016.

²² See Rev. Rul. 81-207, 1981-2 C.B. 57.

²³ See *Stahl Specialty Co. v. U.S.*, 551 F. Supp. 1237 (W.D. Mo. 1982).

partners who report inconsistent treatment between items from their Schedule K-1 and amounts entered on their individual returns. As discussed above, in tiered partnership structures involving lower-tier feeder entities, the determination of the types of losses will need to be made at the lower-tier partnership level. Thus, an individual partner in a feeder partnership that in turn is invested in a fraud will have a strong preference in how the intermediary partnership reports the loss. Although it is possible for an individual taxpayer to report inconsistent treatment on their individual tax return from the amounts received on their Schedule K-1, tax professionals may view this position as aggressive. Additionally, in situations where certain investors do not dispose of their entire partnership interest, the amount of the loss may be limited to the extent the activity is passive under §469.

Not unlike the complications that exist for partnerships contemplating the amendment of open year returns due to phantom income and overstated assets, similar issues will exist related to estate and gift tax filings. The key component of any gift transfer or estate tax calculation centers squarely on valuation. If a significant component of the value of the estate or gift turns out to be a fraudulent investment, a litany of issues will be sure to follow. In the tax context for instance, the estate, or donor in cases of gifts, might realize they overpaid taxes based on a fraudulently inflated value. Unfortunately, the regulations focus on facts available at the applicable valuation date (date of gift, date of death, or alternate valuation date).²⁹ “Available,” in this context, means “discoverable by reasonable inquiry.”³⁰ Given the difficulty of independently uncovering a Ponzi scheme, an executor or a donor may find it very difficult to convince a court that the subsequent discovery of the fraud should be taken into account in the valuation of an investment that later is determined to be a Ponzi scheme. Amended returns or claims for refund should be considered only if it is determined after a full review of case law, some of which has acknowledged the effect of subsequent events,³¹ that a sufficiently reasonable basis exists. For gift tax filers using Form 709, the amendment process calls for using the same forms but indicating that the updated filing is amending a prior filing. If amending Form 706, the executor should follow the special procedures detailed in the Form instructions. The executor also might consider an estate

tax deduction for “losses during administration”³² instead of a valuation adjustment. If applying for a refund Form 843 should be used, attaching an amended Form 706 or Form 709 to show the calculations.

The prospect of receiving ordinary theft loss treatment might compel many investors to forgo amending prior open year returns in order to reduce prior capital gains, and instead attempt to treat the full loss as a theft. Theft loss will afford a taxpayer ordinary loss treatment, which can be much more favorable than capital loss treatment (see the example above where a long-term investor actually received a positive gain on investment post tax). As mentioned previously, §165(a) allows for the deduction of any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(c) limits losses in the case of individuals to: (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) losses not connected with a trade or business or entered into for profit if the loss stems from certain casualties or from theft. Although it may seem straightforward that taxpayers would classify their investment activity as being entered into “for profit,” thereby falling under §165(c)(2), there does exist a view in the professional community that *all* theft losses for individuals fall within §165(c)(3). This is important because under §165(c)(3) losses are allowed only to the extent they exceed 10% of adjusted gross income. For higher income taxpayers this limitation may severely diminish, or even eliminate, the benefit of the theft loss under §165.

Section 67 limits certain itemized deductions in the case of individuals. Section 67(a) provides that “. . . itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.” However, §67(b) provides a specific exclusion for theft losses. Under §67(b) all miscellaneous itemized deductions shall be limited other than, among others, “the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c). . . .” Since either direct investment or investment in an investment partnership should be deemed as entered into for profit, the losses associated with the investment should not be limited by §67. Additionally, the losses are provided a specific exclusion under §68, which imposes an overall limitation on itemized deductions.

In addition to not being limited based on type of deduction under §67, or limited by adjusted gross income under §68, theft losses are available to be car-

²⁹ See Regs. §§20.2031-1(b) and 25.2512-1.

³⁰ *Necastro Est. v. Comr.*, 68 TCM 227 (1994), and *U.S. v. Simons*, 346 F.2d 213 (5th Cir. 1965).

³¹ See *Noble Est. v. Comr.*, T.C. Memo 2005-2 and cases cited therein.

³² §2054.

ried back to prior years and carried forward to future years. Section 172 describes the treatment of net operating loss deductions for individuals and other types of taxpayers. Theft losses for individuals are eligible for carryback, generally three years, which can be accomplished by amending returns using Form 1040X. A refund of prior year tax payments can also be expedited by using Form 1045 where applicable. The IRS must process a filed Form 1045 by the later of: (1) 90 days from the date the completed application for refund is filed, or (2) the last day of the month that includes the due date (including extensions) for the current period return. Additional theft losses, not used as part of the carryback process, can then be carried forward for a period of 20 years.

A less likely, but not unrealistic, situation might arise if the IRS denies a current deduction of theft loss where the taxpayer has already paid tax on prior fictitious income. To mitigate the net tax loss a taxpayer would suffer in this situation, there exists a mechanism under §1311 to potentially remediate this problem. Section 1311 mitigation is available in situations where items have been erroneously reported and inconsistently treated by either the taxpayer or the IRS; it applies to situations where adjustment is not possible, such as in cases where the statute of limitations has expired and return amendment is not available. Mitigation is a complex area and can be hard to achieve; however, prior year errors that affect partner basis calculations are one example of a specific item to which this code section applies.³³ Under the above scenario, an IRS determination of disallowance may qualify for §1311 mitigation, as the IRS would have allowed for increases in tax basis during years of reported gain but subsequently disallowed losses on increased adjusted basis amounts.

WORTHLESS SECURITY RECOGNITION / ABANDONMENT OF PARTNERSHIP INTEREST

When a partnership interest becomes worthless, how is this accounted for? What is actually happening when this occurs? Is there a tax loss, and if so what is the character?

If the goal of the taxpayer is to realize a tax loss for a worthless investment, a logical starting point might be to consider §165(g), which describes conditions necessary for realizing losses on worthless securities. Under §165(g), securities are defined as (1) a share of stock in a corporation; (2) a right to subscribe for, or to receive, a share of stock in a corporation; or (3) a bond, debenture, note, or certificate, or other evidence

of indebtedness, issued by a corporation. Regulations under §1.165-5(c) go on to state that if any security, as defined above, that is a capital asset becomes wholly worthless during the taxable year, a capital loss will be allowed as if a sale or exchange occurred on the last day of the year. Unfortunately, to the holder of a partnership interest, the discussion of worthless securities under §165(g) will provide little guidance. Fortunately there exists a mechanism, not unlike theft losses, that could provide partnership interest holders ordinary loss treatment.

In the partnership context, taxpayers could potentially realize benefit if their interest becomes worthless or they “abandon” their interest. Although §165 does not use the term abandon, Regs. §1.165-2(a) refers to obsolescence of non-depreciable property, which has become known as abandonment in case law. The regulation allows as an ordinary loss “a loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any non-depreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use. . . .” Subsection (b) of Regs. §1.165-2 precludes subsection (a) from applying to losses sustained from the sale or exchange of property, i.e., capital transactions. As discussed below, a partner must determine that their relinquishing of partnership interest does not constitute a sale or exchange to qualify for ordinary loss treatment.

The concept of abandonment as it relates to partnership interest is fairly well litigated.³⁴ Prior to 1993 however there was inconsistency cross circuit which created confusion. Much of the confusion resulted from the interpretation of what constituted a “sale or exchange,” which is a crucial ingredient needed in recognizing a capital gain or loss provided in definitions set forth under §1222. Ultimately, this caused the IRS in July of 1993 to issue Rev. Rul. 93-80,³⁵ which sought to clarify issues surrounding the abandonment or worthlessness of partnership interests.

Rev. Rul. 93-80 summarizes two distinct situations as follows. In situation one, a partner abandons their partnership interest and at the time the only liabilities of the partnership are nonrecourse and are shared equally among the partners. Situation two is the same as situation one except that the abandoning partner in this instance does not share in the liabilities.

In situation one, the abandoning partner realizes a capital loss because the partner is deemed to receive a

³⁴ See *Citron v. Comr.*, 97 T.C. 200 (1991), *Echols v. Comr.*, 950 F.2d 209 (5th Cir. 1991).

³⁵ 1993-2 C.B. 239.

³³ See §1312(7).

distribution under §752(b). This deemed distribution triggers the application of §731. Under §731(a), “any gain or loss recognized. . . shall be considered as gain or loss from the sale or exchange of the partnership interest. . . .” In situation two, the abandoning partner may treat the loss as ordinary under §165(a). In this case §731 was not triggered as there was no actual or deemed distribution, thus there is no “sale or exchange” of partnership interest.

What then are the conditions necessary to prove abandonment of one’s partnership interest? To establish the abandonment of an asset, the taxpayer must show an intention to abandon the asset and must overtly act to abandon the asset. Establishing the abandonment of an asset, much like establishing the worthlessness of an asset, is based on all the pertinent facts and circumstances involved. Much like the analysis involved in considering a theft loss, determining whether abandonment of a partnership interest makes sense is very fact specific. Also, depending on the size of the loss taken on an abandonment of partnership interest, a taxpayer might have to disclose a reportable transaction as described in Regulations under §1.6011-4. For individuals who incur a loss of \$2 million or greater in a single year, or \$4 million or greater over multiple years, as a result of abandoning a partnership interest, Form 8886 may be required to report the transaction.³⁶ Before taking any action, investors should make sure they have all the pertinent facts in place and retain professional tax counsel to help guide their tax decision-making process.

One last option available to a taxpayer is a straightforward sale of the investment which would result in capital loss treatment. This might be the best option if

a determination is made that qualifying for a theft loss or qualifying for abandonment is not possible. Under this scenario, the taxpayer will gain back the benefit of determining the timing of the loss, i.e., they can decide when a closing transaction takes place. This process might prove more difficult where an investor owns an interest in an investment partnership, as many subscription documents contain standard language around non-transferability of interest. This language exists to protect the fund from being deemed “publicly traded,” which could result in an entity-level tax. In cases where an investor is willing to take a complete capital loss and forfeit any potential for recovery, however, there is always the possibility of lining up an arm’s-length bona fide sale transaction to achieve this. To ensure loss recognition it is important that the sale occur at arm’s length and must not be to a related party under §267.

With the 2009 investing year already under way, it would be nice to simply forget about certain events occurring within 2008. Unfortunately, many of the events occurring during 2008 may have long-term implications that could prove irresolvable even over the next 12 months. For investors trying to make sense of the myriad potential options for maximizing future benefit, or minimizing future loss, the best strategy — as is always the case in a tax context — is to be well armed with information.

If you have any questions on the above referenced information please feel free to contact Dave Earley at Deloitte Tax LLP, dearley@deloitte.com, 617-437-2096.

This article does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader’s particular situation.

³⁶ See Rev. Proc. 2004-66, 2004-50 I.R.B. 966.

Bill Would Have Far-Reaching Effect On Gift and Estate Tax Valuation

by Jonathan Blattmachr, Esq., and Scott Nammacher*

Rep. Earl Pomeroy (D-N.D.) has introduced a bill (H.R. 436) that would have significant impact on the value of interests in real estate, investment holdings, and possibly operating entities for estate and gift tax purposes, echoing proposals made during the Clinton administration.

Certain aspects of the proposed bill seem to be difficult to discern, and further refinements and debate are surely going to come if it moves forward in committee. But, if enacted, it or similar bills likely will change the valuation of these kinds of “property” in many cases.

SOME FUNDAMENTAL VALUATION CONCEPTS

Valuation is an important factor in estate and gift taxation. The more property or assets are worth, the higher the tax, as a general rule.

Other than for directly owned publicly traded stocks and bonds, the estate and gift tax value of property interests held in a legal entity is usually determined by deciding at what price the property would change hands between a “willing buyer” and a “willing seller” — essentially, what the price would be if the interest was bought and sold by two unrelated parties (a “fair market value” level). That is the case, for example, for privately held business interests, real estate interests, and works of art.

The law currently provides that the nature of the property must be considered in determining its value. For example, an interest in an entity that does not represent control, where the owner cannot force its liquidation to obtain ownership of the underlying assets or to direct the entity’s affairs, is worth less, and often far less, than an interest that does represent control of the enterprise.

Historically, prior to 1993, the Internal Revenue Service argued “family attribution” and attempted to

aggregate all family interests. To the extent there was control at the family level, they disallowed any consideration for minority interests, assuming that families act in concert.

Over time, IRS lost a number of tax cases, and ultimately conceded the family attribution issue.¹ This allowed for transfers to occur at “fair market value” levels, rather than at very inflated prices with no discounts.

This bill is an attempt to legislate the earlier family attribution concept into law, in spite of the history of case law in direct contradiction to its reasonableness.

NO MINORITY DISCOUNT FOR “NON-BUSINESS” ASSETS

In essence, if an interest in a business controlled by a “family” unit were transferred, H.R. 436 would require that any “non-business” assets (stocks, bonds, excess cash, non-working capital, or land, etc.) be valued without any minority discount treatment. Such assets would be valued as if a proportionate interest in these assets were transferred directly by gift or at death.

The bill is unclear whether it is attempting to also preclude marketability discounts against these assets as well. This treatment would occur even though the estate, or person making the gift, does not control the entity and could not get to those assets if they wanted or needed to.

Who constitutes “family” includes a wide net of related parties, including different levels through marriages. Real estate owned by a partnership where a “family” controls, for example, will be treated as a passive asset unless the taxpayer “materially participates” in the operation of the real estate. Transfers by in-laws and step-descendants who might have small interests would appear to be treated as if they control — with taxes on values they could never realize in true third-party sales.

Although not expressly stated, the bill would treat assets such as publicly traded stock, bonds, cash, and similar portfolio-type investments held in a family investment partnership as though they had been transferred directly to the donees, rather than interests in a partnership being transferred.

Specifically, the bill would require the taxpayer to determine the passive assets of the entity (possibly all of them in a family investment partnership) and then value the transfer of the total interests as the sum of a proportionate share of the value of the passive assets

* Jonathan Blattmachr is a retired partner of Milbank, Tweed, Hadley & McCloy LLP in New York. Scott Nammacher is managing director of Empire Valuation Consultants LLC in New York.

Copyright Jonathan Blattmachr and Scott Nammacher 2009. All rights reserved.

¹ See, e.g., *Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1999), and *Lee Est. v. Comr.*, 69 T.C. 860 (1978), *nonacq.*, 1980-2 C.B. 2; and Rev. Rul. 93-12, 1993-1 C.B. 202.

(no minority discounts) plus the value of the “active business” interest in the entity (with applicable discounts).

It is unclear whether a lack of marketability discount would apply to the deemed passive assets.

Additionally, if a family-controlled business entity owns an interest of 10% or more (by vote or value) in another business and this business is deemed a “passive” asset, the same “look-through” rules apply — no minority discounts on the non-operating assets in that entity. This even applies to 10% interests owned by that second level of entity . . . and so on!

As indicated earlier, subject to exceptions, interests in family partnerships and businesses are worth less than the underlying assets the partnership owns because interests in family partnerships are worth little to third parties. Tax law has historically imposed estate or gift tax on property, in effect, only at the price a third party would pay for it. In effect, the bill would disregard the existence of an entity such as a family partnership, limited liability company (LLC), corporation, or other entity and treat any gift or bequest as being made of the assets owned by the entity, except for those actually used by the entity in the operation of a business.

POTENTIAL VALUATION IMPACT OF THE BILL

So how does this impact values? For example, in its purest form, assume two siblings, an aunt and nephew, or an individual and her stepgranddaughter’s husband own a combined controlling interest (generally, more than 50%) of the stock in an active company (such as a car dealership, restaurant, or farm) but none owns more than 50% of the stock. The stock owned by either at death would be valued for estate tax purposes without regard to the fact that such a minority interest, in fact, is worth less than a proportionate part of the business valued as a whole.

This rule applies even if, on account of animosity or for many other reasons, the related owners would not dispose of their interests together. (In fact, if there were deemed to be excess assets in the business that were considered “passive,” these might even be valued separately without discounts, even though the estate may not have any access to them.) This could im-

pact values by anywhere from 5% to 25% or more depending on the specific facts and circumstances.

In essence, the tax to be applied in the estate valuation would actually have to be based on levels of value that are unrealizable in the real world, especially to anyone other than a single controlling shareholder with the power to liquidate or direct distributions. The value would be higher than any value the estate would likely be able to achieve upon selling the interest to third parties and, likely, even to insiders.

This would lead to a kind of “super tax” applied to entities deemed to be family-controlled, regardless whether these were the controlling persons or not.

These changes in valuation would be in effect for transfers after the date the bill is enacted. The bill would be applied on a prospective basis only to transfers after the date of enactment.

BILL WOULD EXTEND \$3.5 MILLION EXEMPTION AND 45% RATE

The bill would make other changes that are similar to proposals others have made. It would extend the current \$3.5 million estate tax exemption indefinitely.

The bad news for some taxpayers is that there would be an estate tax in 2010 — under current law, there is no estate tax for that year. The good news is that the \$3.5 million exemption would stay in effect even after 2010, when the exemption was scheduled to be pared back to \$1 million.

The bill would keep the current 45% tax rate in effect (it was scheduled to rise to 55% after 2010) but it would impose a type of limited surcharge for a taxable estate exceeding \$10 million.

WHAT TAXPAYERS SHOULD DO

The bill, if enacted, would not necessarily mandate that taxpayers modify their basic estate planning documents, such as wills and revocable trusts. However, property owners who own interests in private entities, whether they are active businesses or management vehicles, probably should consult with their estate planning advisers to determine whether action should be taken before the bill becomes law or to determine whether overall estate planning (such as acquiring additional life insurance) should be changed.

The Intersection of Income In Respect of a Decedent, The Separate Share Rule And Making Charitable Bequests — Be Sure to Look All Ways Before Crossing

by Marc S. Bekerman, Esq.
New York Law School
New York, NY¹

INTRODUCTION

Post-mortem income tax planning relies on a number of concepts, including income in respect of a decedent, the separate share rule and the charitable deduction allowable to an estate for fiduciary income tax purposes. In addition, effective post-mortem income tax planning is often dependent on actions and documents executed by the decedent during his or her lifetime. This article will review an estate planning situation in which these separate principles converge and discuss the planning steps taken to best effectuate the client's testamentary intent in a tax-advantaged manner.

OVERVIEW OF INCOME TAXATION OF ESTATES

A brief introduction as to how an estate's income is subject to taxation is appropriate to understand the tax implications discussed in this article. Subchapter J of the Internal Revenue Code ("IRC" or "Code"), which governs the income taxation of trusts and estates, draws from various income tax concepts in providing the income tax rules for trusts and estates.²

Subchapter J indicates that the general rules of the Code apply to the income taxation of an estate unless

¹ Marc S. Bekerman is the Associate Director of the Graduate Tax Program at New York Law School where he is also an Adjunct Professor of Law teaching a variety of courses relating to trusts and estates. In addition, Marc continues to maintain his private practice where he concentrates in all areas of trusts and estates.

² In most respects, Subchapter J imposes similar rules on the income taxation of estates and trusts. However, as this is a review of a plan for post-mortem fiduciary income tax savings, the article will usually refer to the income tax rules as they apply to the income taxation of estates.

Subchapter J specifically provides otherwise. As a result, the income taxation of an estate starts with the basic concepts of income, reduced by deductions and exemptions, to calculate the estate's tentative taxable income to which any available credits are applied to determine the estate's income tax liability.

One of the primary distinctions between income taxation of an individual and income taxation of an estate is the availability to an estate of a deduction for income distributions made during the estate's fiscal year frequently referred to as a distribution deduction.³ The purpose of the distribution deduction is to allow an estate to distribute its income, and the corresponding income tax liability, to the beneficiaries of the estate.⁴ The result of the distribution deduction is to tax the income of an estate as a hybrid; to the extent that an estate distributes its income to its beneficiaries, it is merely a pass-through entity for income tax purposes similar to a partnership.⁵ However, to the extent that an estate does not distribute its income to its beneficiaries, there is no distribution deduction available and the estate will be its own taxpayer and must calculate and satisfy its own income tax liability.

DISTRIBUTABLE NET INCOME

Distributable net income, commonly known as DNI, is defined by §643. Essentially, DNI is the amount of income that can be distributed to the beneficiaries of an estate or trust, and is computed by calculating the taxable income of the entity without considering any deduction for distributions or personal exemption, nor any capital gains or losses.

DNI is a key concept since it will be the maximum amount that will qualify for the distribution deduction under §651 or §661 of the Code.⁶ This is essential since, as discussed above, the effect of the distribution deduction is that it transfers the income tax consequences from the estate to the beneficiary.

³ Another difference between an estate and an individual taxpayer is that an estate is permitted to elect a fiscal year where an individual cannot. An important distinction between the income taxation of trusts and the income taxation of estates is that most trusts cannot elect a fiscal year and must use a calendar year similar to an individual. *See* §644.

⁴ It should be noted that the distribution deduction is not elective.

⁵ As with a partnership, an estate will still be required to file a fiduciary income tax return (Form 1041) if its gross income exceeds the exemption amount of \$600, even if all of its income has passed through to the beneficiaries. The Form 1041 will include Schedules K-1 issued to the beneficiaries to provide them with the income tax consequences of the distributions which they have received from the estate.

⁶ Section 651 allows for a distribution deduction for simple trusts (trusts that must distribute all of its income on an annual basis). Section 661 allows for a distribution deduction for complex trusts (all non-simple trusts) and estates.

There are certain rules that need to be observed in reporting DNI:

- Under §663(a), no DNI is carried out of an estate by a distribution of either a specific bequest, or a general legacy that is properly paid in not more than three installments;
- DNI is usually carried out of the estate by distributions to residuary beneficiaries. These distributions can be of either “income” or “principal”;⁷ and
- The allocation of DNI among beneficiaries is provided for and discussed fully in the Treasury Regulations (hereinafter “Regs.”) promulgated under §661.

SEPARATE SHARE RULE

The separate share rule will apply if there are substantially separate and independent shares of an estate having more than one beneficiary. “Separate economic interests” exist where the economic interests of the beneficiaries are not interdependent. Some examples of separate shares include:

- A surviving spouse’s elective share if it shares in estate income.⁸ Regs. §1.663(c)-1(a);
- Any formula pecuniary bequest or formula marital deduction provision that shares in the estate’s income, or if it is not entitled to share in income, appreciation, or depreciation, is not required to be paid in more than three installments. Regs. §1.663(c)-4(b);
- A qualified revocable trust under §645 will always be a separate share whether the §645 election is or is not made. Such trust may itself be divided further into additional separate shares. Regs. §1.663(c)-4(a).

The separate share rule of §663(c) applies to the estates of decedents dying after August 5, 1997. Regs. §1.663(c)-1-1.663(c)-6 will also apply if the decedent died after December 28, 1999. If separate share treatment is applicable, it is not elective and the separate shares come into existence at the earliest moment that the fiduciary can determine that the separate shares exist.

⁷ In other words, the estate cannot change the tax effect of a distribution by characterizing it as a principal distribution, as opposed to an income distribution.

⁸ If the elective share is not entitled to share in estate income, or in the appreciation or depreciation of value of estate assets, but is determined at the date of death, it is still a separate share. Regs. §1.663(c)-1(a).

The purpose of having the separate share rule apply to estates is to promote fairness in that a beneficiary does not get taxed on another beneficiary’s income (i.e., a beneficiary can only be taxed on his pro rata share of estate income). Where there are separate shares, a fiduciary may use any reasonable method of making the allocations, valuations and calculations required by the regulations.⁹ Although deductions and losses are generally allocated on a pro rata basis, deductions and losses are to be allocated separately if they can be identified with a particular share. Regs. §1.663(c)-1(b)(5).

DNI is calculated separately for each separate share, and the estate’s gross income is allocated in accordance with the income to which each share is entitled under either state law or the governing instrument. As separate shares are used for purposes of allocating DNI, it is questionable whether a specific bequest can be a qualified separate share since, as discussed above, DNI is usually not allocated to a specific bequest.¹⁰

CHARITABLE DEDUCTION FOR FIDUCIARY INCOME TAX PURPOSES

As discussed above, an estate is a taxpayer which must report its income and deductions on a timely filed fiduciary income tax return and pay any applicable income tax. Although §170 governs the charitable deduction permitted to individuals on their personal income tax returns, Subchapter J supersedes these rules for the charitable deduction available to trusts and estates for use on their fiduciary income tax returns.¹¹ One important distinction between the charitable deduction available for personal income tax purposes and that available for fiduciary income tax purposes is that the trust or estate can use the charitable income tax deduction to deduct up to 100% of its income as shown on its fiduciary income tax return. This is in stark contrast to the rules contained in §170 which limits an individual taxpayer’s charitable deduction for personal income tax purposes to a per-

⁹ Any allocation of income to charity is governed by §642(c), not the separate share or DNI rules. Regs. §1.663(c)-5, *Ex. 11*.

¹⁰ This will be an important point in our planning later in this article.

¹¹ Although this article will focus on the post-mortem income tax planning issues, it is important to recall that there is also a separate charitable deduction permitted for estate tax purposes so long as the bequest meets the requirements of the IRC. As a general rule, a charitable deduction for estate tax purposes will be allowed if the bequest passes to a qualified charitable organization in a qualifying manner. Although this can raise complicated issues, for purposes of this article the charitable deduction for estate tax purposes will be available to the estate as the organization qualifies for the deduction and the bequest is an outright gift.

centage of their adjusted gross income as shown on their personal income tax return, the actual percentage being determined by several factors including the nature of the recipient of the gift and the type of property gifted.

It is important to note that an income tax deduction is permitted to an estate only if the charitable organization which receives the distribution is a permissible beneficiary under the terms of the governing instrument.¹² Further, the charitable deduction for fiduciary income tax purposes is only available if the charity is receiving income from the estate. As a typical general legacy to a charitable organization is payable from the principal of the estate,¹³ there is no income tax charitable deduction permitted by satisfaction of the bequest.¹⁴

INCOME IN RESPECT OF A DECEDENT

Income in Respect of a Decedent, frequently known as IRD, is income that the decedent was entitled to receive at the time of his death. Some examples of IRD include:

- unpaid salary;
- retirement plan benefits;
- dividends that were declared but not paid prior to the decedent's death;
- realized gain deferred under the installment method of accounting; and
- interest due to the decedent (including accrued interest on U.S. Savings bonds if not reported by the decedent prior to her death).

IRD is governed by §691. Assets which fall within the definition of IRD are both includible in the gross estate for estate tax purposes of the account owner and also constitute taxable income to the recipient. It should be noted that, under §691(c), a person who received IRD and includes it in their gross income for a given tax year is entitled to deduct in the same tax year the estate tax associated with such asset.

The growth in popularity and value of Individual Retirement Accounts and similar arrangements has in-

creased the importance of appropriate planning for clients who have assets which will constitute IRD. Often the technique for dealing with assets that will constitute IRD is to plan so that the income can be spread out over as long a period as possible to avoid bunching of income in a particular year and continued tax-deferred growth where possible.¹⁵ Another possible use of IRD assets in a tax-advantaged manner is to use such assets to satisfy the client's charitable inclinations since, if properly done, an estate tax deduction may be available and there will be no income tax consequences.¹⁶

An estate will have to pay income tax on IRD items on a cash basis (i.e., once the income is collected). As a general rule of income tax planning, taxpayers seek to avoid or defer income tax when possible, which makes the deferral of IRD one possible goal of estate administration. However, an executor may choose to accelerate IRD as part of a post-mortem tax plan if there are expenses being paid in a particular taxable year that would qualify as deductions and it is in the best interest of the estate to offset these deductions with income.

Often the best planning for minimizing IRD takes place during the estate planning stage before the decedent's death. However, there are certain post-mortem planning opportunities that an estate may use depending on the type of IRD involved. We will quickly review a few techniques:

1. *Savings Bonds* — An estate can elect to report the accrued interest not previously reported on the decedent's final personal income tax return. This may have the advantage of the interest being taxed at a lower rate, or providing income to utilize deductions and exemptions that might otherwise go unused.

2. *Retirement Accounts*

- a. Pre-death — Analyze whether the client may be better served by reducing or foregoing a contribution to a retirement plan, and instead make a gift of the after-tax dollars to the beneficiaries. Additionally, revised beneficiary designations may be helpful in many instances.

¹² As a charitable organization cannot receive a distribution under the intestacy laws, it is presumed that the decedent's Will is the governing instrument. However, the analysis herein should be equally applicable to situations where the estate plan utilizes a revocable trust with a pourover Will.

¹³ An example of the legacy contemplated is "I leave the sum of Ten Thousand Dollars to Qualifying Charitable Organization."

¹⁴ Of course this bequest may provide a charitable deduction for estate tax purposes as discussed above.

¹⁵ When estate planning for retirement benefits, it is essential to understand the minimum distribution rules which will apply to the client during his or her lifetime and govern the distributions to the proposed beneficiaries after the death of the client.

¹⁶ If a charity is the designated beneficiary of an IRD asset, the estate will have no income on the collection of the asset as the estate does not receive the income. Further, the charity will not have to pay income tax on the receipt of the IRD item.

b. Post-death — It may be in the interest of the beneficiaries of retirement accounts to withdraw the balances over the period of time allowed by law, as opposed to withdrawing the entire amount immediately after the decedent's death.

3. *Disposition of IRD Items at Death* — Consider specifically bequeathing IRD items to beneficiaries in lower income tax brackets, or to a tax-exempt entity, especially when the client has charitable desires. It may reduce the overall income tax bite to the estate and its beneficiaries.¹⁷

There are special problems regarding assets which constitute income in respect of a decedent (“IRD”) and the separate share rule. IRD items are allocated among the separate shares that could potentially be funded with the IRD amounts, whether or not such shares would otherwise participate in income.¹⁸ This allocation is made pro rata, based on the relative value of each share.¹⁹ This allocation of IRD could shift income tax liability to trusts otherwise protected from estate tax or GSTT by the use of the decedent's exemptions. As such, it is suggested that a draftsman consider inserting language to limit the possible recipients of IRD items.

CLIENT SITUATION

The author was retained by an estate planning client with the following characteristics:

- The client has sufficient assets to create an estate tax liability under current law;
- Much of the client's assets were various retirement accounts that will constitute IRD to her estate or its beneficiaries upon her death;
- The client's primary beneficiaries are her siblings:
 - The siblings are not financially wealthy and are expected to immediately liquidate any IRD items left to them and pay the associated income tax liabilities;

- The client wishes to leave her siblings their interests outright and free of trust;
- The client serves on the board of a charitable organization and wishes to make a significant bequest of a specific dollar amount to the organization under the terms of her estate plan (the client also wants to retain the ability to change the amount of the gift should she resign from the board).²⁰

ANALYSIS

As the client wishes to reserve the right to alter the amount of the charitable bequest, the assets to be used to satisfy the bequest will need to be included in the client's gross estate for estate tax purposes.²¹ This is not of great concern since the estate will be entitled to an offsetting charitable deduction for estate tax purposes as the gift will be an outright gift to a qualifying organization.

An additional goal of the overall estate plan is to lower the fiduciary income taxes that will ultimately be payable by the client's estate after her death. Fulfilling this goal will reduce the administration expenses of the estate, and correspondingly increase the amount receivable by her residuary beneficiaries. In light of this goal, there are potential fiduciary income tax savings to be gained if the retirement accounts, which will constitute IRD, are used to satisfy the charitable bequest.

The client consulted with her financial institution to obtain copies of her existing beneficiary designations and its current beneficiary designation forms. Upon review of the client's IRD assets, it was determined that her existing beneficiary designation should be changed to achieve the result. Unfortunately, the following complications occurred in consulting with the financial institution:²²

- The institution required a percentage and would not permit a designation which allowed the three siblings to each receive one-third;

²⁰ The charitable organization involved is a qualifying charity under the IRC and bequests to the organization made in proper form will qualify for charitable deductions for both estate tax and income tax purposes.

²¹ The analysis will only examine the planning of the intended charitable bequest and not other issues raised by the client and her wishes.

²² For purposes of this discussion, we will ignore whether the financial institution could be compelled to honor a beneficiary designation that could be created to achieve the client's precise wishes as the client did not want to risk the possibility of the institution failing to honor such a designation after her death, nor the cost of potential litigation to compel the institution to accept the designation.

¹⁷ This technique may also be helpful to avoid certain consequences of the separate share rule discussed above.

¹⁸ In other words, if a separate share could be funded with an IRD item, then it will be deemed to receive a pro rata share of the income generated by the IRD item whether or not it actually receives the IRD items.

¹⁹ Regs. §1.663(c)-2(b)(3).

- The institution's designation provided that the share of a predeceased designated beneficiary would be payable to the surviving designated beneficiaries and not the issue of the predeceased beneficiary;²³
- The institution would not permit the gift of a specific dollar amount to the charitable organization on the beneficiary designation form.²⁴

Given the facts and circumstances, and after further consultation with the client who did not wish to change financial institutions, a course of action was agreed upon that would have the retirement accounts payable to the estate as the designated beneficiary.

This beneficiary designation in favor of the estate does not impact any potential estate tax liability as the assets will be included in the decedent's gross estate for estate tax purposes regardless of who the designated beneficiaries are by virtue of the client's ability to change the designated beneficiary. Further, the usual concerns on deferring the income tax to the beneficiaries and allowing them to continue the tax-deferred growth are not applicable in this situation, given that her siblings intend to immediately liquidate the retirement accounts. As such, there are no negative income tax consequences by having the IRD assets payable directly to the estate. Therefore, there are no negative tax consequences of the proposed beneficiary designation.

Although there are no negative tax consequences of the proposed beneficiary designation, there are certain potential non-tax consequences including:

- As the estate will be the beneficiary, only a properly appointed fiduciary of the estate will be able to collect the IRD assets. This may result in a delay to the ultimate beneficiaries who would otherwise have been able to collect the assets by providing a copy of the decedent's death certificate to the financial institution.
- As the assets are payable to the estate, they will be subject to the claims of the creditors of the decedent's estate. Depending on state law, this may expose these assets to such claims where they may not have been otherwise.
- As the assets will be subject to administration, it may increase the administration expenses of the

estate under state law, including executor commissions, attorney fees and court filing fees.

It is important to note that, when the estate collects the IRD assets, a Form 1099 will be issued to the estate and the income will be includible in the estate's fiduciary income tax return in the appropriate fiscal year. As such, we still needed to plan for the goal of obtaining the charitable deduction for fiduciary income tax purposes for the bequest to the charity in the same fiscal year in which the income will be reported.²⁵

As discussed above, a traditional general legacy does not provide a charitable deduction for fiduciary income tax purposes as it is payable from principal. Further, under the separate share rules and concepts of DNI, it is unlikely the estate could take the position that the charitable bequest was satisfied with the IRD items. After further consultation with the client, it was agreed that the Will would contain an instruction to the Executor to satisfy the charitable bequest from IRD assets first, and from non-IRD assets only to the extent that the IRD assets are insufficient to fully satisfy the bequest.²⁶ This approach should permit the Executor to take a charitable deduction for fiduciary income tax purposes to offset some of the income recognized by the estate in the year the IRD item is collected, thereby reducing the estate's taxable income appropriately for that fiscal year and obtaining the desired charitable deduction.²⁷ Although the author is unaware of any precedent which would bind the Internal Revenue Service to allow the charitable deduction,²⁸ the author proposes that this is the appropriate result based upon the facts and circumstances.²⁹

²⁵ If the timing of the income and deduction are mismatched, the result could negate much, if not all, of the benefit of the income tax deduction to the estate and its beneficiaries.

²⁶ Based upon the client's existing asset mix, it is extremely unlikely that the IRD assets will be insufficient to satisfy the charitable gift.

²⁷ As the charitable deduction is generally available in the fiscal year in which the distribution is made to the charitable organization, subject to certain exceptions, the author believes that the Executor should insure that the distribution to the charity is made in the same fiscal year that the IRD asset is collected by the estate. This can be done through the timing of collection of the asset and the selection of an appropriate fiscal year.

²⁸ PLR 200845029 allowed for a similar result with a defined benefit pension plan interest distributed to a charitable beneficiary in partial satisfaction of its residuary interest. The private letter ruling is distinguishable from the facts presented in this situation in that the charitable beneficiary in such ruling was a residuary beneficiary as opposed to a general legatee; whether this is a distinction with a difference is an issue that the author will likely address in a future article.

²⁹ The author would note that the deduction for the estate tax

²³ It was the client's intent that the issue of a sibling who predeceased her receive their parent's share. This is consistent with the rest of the estate plan given the effect of the New York anti-lapse statute.

²⁴ The client was unwilling to give a percentage of the account to the charitable organization in fear that the account would be worth significantly more or less at the time of her death than its current value, resulting in a distortion of her intended estate plan.

CONCLUSION

As with most estate planning, it is most effective to begin the planning process prior to the client's death. If the estate planning documents are not drafted ap-

attributable to the IRD item pursuant to §691(c) is likely unavailable if the charitable deduction is allowable under these circumstances. However, given the relative benefit to the estate, the author still believes the proposed course of action is overall more beneficial to the estate and its beneficiaries.

propriately, there may be negative tax consequences that cannot be cured after the client's death.³⁰

³⁰ After this article was completed, the Service released PLR 200850004, which reached a similar conclusion to that stated in this article, albeit on weaker facts for the taxpayer as the taxpayer in the private letter ruling reformed the Will to provide for the gifts of the IRD items to the charitable beneficiaries who had been left general legacies under the Will as executed.

LEADING PRACTITIONER COMMENTARY

FLPs — Estate Inclusion of Partnership Interests Under §2036

by Kathleen Ford Bay, Esq.
Potts & Reilly LLP
Austin, Texas

Estate of Erma Jorgensen v. Commissioner, T.C. Memo 2009-66 (3/26/09), is yet another in a long list of reported cases that indicate the scrutiny, and yes, hostility, that the IRS devotes to limited partnerships when the partners are all members of the same family. *Jorgensen* is a blueprint showing attorneys and accountants what not to do and serves as a warning to deter the timid.

Colonel Gerald Jorgensen, who died in 1996, had a distinguished career in the Air Force, from bomber pilot, to attorney with the Judge Advocate General's office, to its diplomatic corps. After retirement, he served as an aide to a U.S. Congressman. During this time, he and Erma fell in love and married; Erma worked as a school teacher and then became a full-time mother of two and a housewife. The Colonel and Erma were frugal and the Colonel became a knowledgeable investor, who adhered to a "buy and hold" strategy, with a portfolio of marketable securities and bonds worth over \$2 million at his death. Mrs. Jorgensen was not interested or involved in financial matters.

Enter the helpful experts. Estate planning attorney no. 1 helped the Jorgensens create revocable trusts and durable powers of attorney in 1994, with an amendment in 1997. In 1995, the Colonel created Jorgensen Management Association ("JMA-I") after consulting with the attorney — none of Erma or their two children were involved in these discussions, although the children and the Colonel were the general partners and the Colonel, his wife, two children, and six grandchildren were the limited partners. Only the Colonel and his wife made contributions, about \$230,000 each for 50% limited partnership interests. In a footnote regarding the interests listed as being owned by the limited partners, the Tax Court notes that while these interests are referred to as "gifts," the use of that term is "for convenience only. We do not intend to imply that Colonel and Ms. Jorgensen's transfers of limited partnership interests were completed gifts for Federal tax purposes."

The next part of the opinion shows that the Tax Court reviewed copies of letters from an attorney to

his client and from sister to brother. After the Colonel died in late 1996, attorney no. 1 wrote Mrs. Jorgensen ("Mrs. J") that for her husband's estate, Mrs. J ought to take a 35% discount on the assets in JMA-I. (There is no indication that there was ever an independent appraisal.) Mrs. J followed the attorney's advice and funded the family trust with \$600,000 of assets, including JMA-I assets at their value using the attorney-recommended minority interest and lack of marketability discounts. Everything else from her husband's estate went outright to Mrs. J.

Then attorney no. 1 recommended that Mrs. J transfer her brokerage accounts to JMA-I, to get a discount both when she made gifts of partnership interests and in her estate. However, even though attorney no. 1 wrote to Mrs. J, he only talked to her son, daughter, and son-in-law. Mrs. J's children and son-in-law decided to form a second entity ("JMA-II"). Attorney no. 1 wrote Mrs. J about this, explaining that low-basis assets would be in JMA-I, high-basis in JMA-II, and Mrs. J would give to her grandchildren JMA-II interests. Mrs. J first contributed about \$1.8 million to JMA-II in marketable securities and then shortly after that another \$22,000 in marketable securities, money market funds, and cash, plus about \$190,000 from her husband's brokerage account that was now hers. As Executor, she also invested in JMA-II, with the result that she owned 79.69% and the estate 20.31% of JMA-II — the two children were general partners and also limited partners with their children. Mrs. J started gifting interests in JMA-II to her children and grandchildren, using November 1996 values, even though the gifts were being made in mid-1997. Mrs. J did not file any gift tax returns, even though the values exceeded the annual gift tax exclusion.

Enter estate planning attorney no. 2 in 1999. The daughter consulted the attorney about Mrs. J transferring her lifetime exemption to her family — then \$650,000. In October 1998, attorney no. 2 wrote Mrs. J about discounts, noting that she would need to hire an expert appraiser "to have any chance of justifying the discounted value of a limited partnership interest if a gift or estate tax return is audited." Later that month, attorney no. 2 requested such an appraisal of a 1% interest in JMA-II, stating "[t]he partnership's sole activity is to hold and invest securities." There was little, if anything, done to keep the JMA-II separate from Mrs. J's personal matters — even though she did not need the assets day-to-day, she used them as a fall-back for her personal affairs and to make gifts of cash to family members, and she had check-writing privileges on each partnership. The general partners did not reconcile checking accounts and one of them never looked at check registers. (The son was apparently quite honest when deposed about his understanding or misunderstanding of the partnerships, his

borrowings from them, and the like.) Attorney no. 2 billed partnership and personal legal work on one bill, not separately.

Mrs. J died in 2002. In 2003, her children paid the Federal and California estate tax liabilities (as they had calculated them) from JMA-II: \$179,000 and \$32,000. The IRS assessed a deficiency of nearly \$800,000. After concessions, two issues were presented to the Tax Court: (1) whether the assets Mrs. J transferred to JMA-I and JMA-II are included in her estate under §2036(a), and (2) whether the estate should get “equitable recoupment” (an interesting issue, but one that had little financial effect, presumably, and is not discussed further in this analysis).

Factors that persuaded the Tax Court, using a preponderance of the evidence rule, to tax in Mrs. J’s estate under §2036(a) the value of the assets she transferred to the two partnerships (63.124% in JMA-I and 79.69% in JMA-II) were:

- (1) The assets in each partnership consisted entirely of marketable securities, cash, and bonds. There was no active management.
- (2) Mrs. J showed no interest in the partnerships’ activities.
- (3) Partnerships were not needed to help Mrs. J manage assets, were not needed for centralized control, because she had a revocable trust and a power of attorney and management could easily be accomplished through these and the partnerships were unnecessary.
- (4) Having the securities in partnerships did not result in an economy of scale pooling of assets, lower operating costs, less need for administrative compliance, and better attention from service providers. The government’s attorneys called on the family’s investment advisor, who testified that simply by linking investment accounts family members would have received the same attention. The court itself noted that “[w]e also doubt that giving securities to each of the children and grandchildren would have been less costly or complicated than creating two limited partnerships, each registered with the Commonwealth, requiring registered agent, annual report to the Commonwealth, and the filing of annual Federal income tax returns and Schedules K-1.”
- (5) Partnership formalities were not followed — a requirement that pro rata distributions be made was ignored; the son who was a general partner borrowed for personal expenses (a home) and did not fully appreciate that partnerships were entities separate from the family and that gifts should not be made from them. Mrs. J, though not financially dependent on the partnerships for her day-to-day

expenses, did look to them for distributions when she did not have enough cash to satisfy her gift-giving.

- (6) All the non-tax reasons given for Mrs. J forming the partnerships were not given contemporaneous with their formation, and as to Mrs. J, could not have been, as she was not the one directing the lawyers, and were first written well after formation and funding “by an attorney [no. 2] preparing for potential litigation with respect to the gift. Thus, we give it little weight.”
- (7) “The use of a significant portion of partnership assets to discharge obligations of a taxpayer’s estate is evidence of a retained interest in the assets transferred to the partnership.” So, paying estate taxes out of JMA-II indicated, to the Court, that Mrs. J retained possession and enjoyment of the assets representing those partnership interests.

There are several lessons to be learned from the *Jorgensen* case. If a client is a member of a family limited partnership, expect that the IRS is going to look closely at the valuation of the interests in that partnership. The client should also expect an estate tax audit, and should budget for the legal expenses. The attorney should expect that nothing said in writing will be protected by the attorney-client privilege. It is also essential to let appraisers who are experts do their jobs and attorneys should not just say, “it looks like a 35% discount can be taken and then we’ll negotiate it down if audited.”

In the planning stages, attorneys should not focus clients on discounts — discounts might be an ancillary result of the planning done by the family for other reasons, which the IRS will analyze. The partners should be involved in the planning process and not just sit idly by and sign when shown the signature line. The partners should discuss the business aspects of the partnership arrangement — whether it is an active business or not, focusing on the pros and cons of restructuring the way business and investment activities are currently being conducted and how they will change if a partnership is used. If other partners can actually contribute assets to the partnership rather than waiting to receive interests by gift, that also sits better with the IRS. Another practice point is that the attorney, accountant and financial advisors bill the partners and the entity separately, depending on who is receiving the advice.

There are also lessons to be learned about gifting. If gifts are made, the client should get a real appraiser to set the value of the gifts and file gift tax returns if the value exceeds the annual gift tax exclusion, and maybe even if the gift does not. The case also highlights that it is essential to observe the governing

documents of the partnership — do not make non-pro rata distributions if they are not allowed. Attorneys should analyze for the client whether making gifts of partnership interests is going to be simpler than giving undivided interests in the underlying assets. It is also essential to plan ahead whether having assets preserved through the partnership will aid in making monies available for the education of younger family members who are presumably limited partners or whether these assets should be maintained in another more easily accessible form of ownership for these eventual education needs.

The Tax Court has said, many times now, that “tax-payers often disguise tax-avoidance motives with a rote recitation of nontax purposes.” If an IRS officer looks at the partnership and does not immediately see and understand the nontax planning reasons for the partnership’s existence, there will be a major difference of opinion and probably quite a fight. The Tax Court highlights that if there are other methods for the pooling of assets to save investment fees, the partnership purpose of saving investment fees will be questioned. Also, a partnership purpose of creditor protection will not be a persuasive partnership purpose if none of the partners have legitimate creditor concerns. Very general creditor protection concerns will not be sufficient. Of course, once a creditor is more than theoretical, fraudulent conveyance statutes may prohibit planning. Clients who want to establish a limited partnership with family members should read the *Jorgensen* case (or another, but *Jorgensen* is quite readable) before going forward. Perhaps the client should have a “due diligence” check done on a regular basis, either by the general partner(s) or an outside accountant or lawyer, to make sure that the partners are using the partnership properly. Rest assured, the IRS will continue to challenge family limited partnerships.

Service Rules Favorably on Private Split-Dollar Insurance

by Beverly R. Budin, Esq.

Ballard Spahr Andrews & Ingersoll, LLP
Philadelphia, PA

In PLR 200910002, the Service ruled favorably on the gift and estate tax issues in a split-dollar insurance arrangement. Husband and wife created an irrevocable trust (the “Trust”), which purchased a second-to-die life insurance policy on the lives of the settlors. The Agreement between the Trust and the settlors provides as follows:

1. The Trust will own the policy.
2. During the joint lives of the settlors, the Trust will pay an amount equal to the insurance company’s

current published premium rate for annual renewable term insurance generally available for standard risks; and after the death of one of the settlors, the Trust will pay an amount equal to the lesser of (i) the amount provided in Notice 2001-10, 2001-1 C.B. 549, or subsequent IRS guidance and (ii) the insurer’s current published premium rate for annual renewable term insurance generally available for standard risks. The settlors (or the surviving settlor) will pay the balance of the premiums.

3. The Trust will collaterally assign the policy, giving the settlors the following rights:

- a. At the death of the survivor of the settlors, the survivor’s estate will receive the greater of the cash surrender value of the policy or the cumulative premiums paid by the settlors.
- b. If the Agreement terminates during lifetime, the settlors (or surviving settlor) will receive an amount equal to the greater of the cash surrender of the policy or the premiums paid by the settlors “to the extent the trust has other assets.” [Nothing in the PLR indicates whether the Trust is to hold any other asset.]

4. Except as noted above, the Trust retained all other rights in the policy.

The Service ruled that the arrangement would not result in a gift by the settlors and the insurance proceeds would not be includible in either settlor’s estate.

In reaching its conclusion regarding the gift tax issue, the Service weaved its way through the complex regulations in §1.61-22. The following should be noted:

1. The arrangement falls under the “economic benefit regime,” which measures the economic benefits to the Trust (rather than the “loan regime,” governed by §7872).

2. After the death of one of the settlors, the Trust pays the “lower of” the IRS table and the insurance company rates. While both settlors are living, there is no sanctioned IRS table to use and, therefore, the Trust pays the insurance company rates.

3. If the policy is maintained until the death of both settlors, the insurance proceeds will provide sufficient funds to pay the estate of the surviving settlor the greater of cash value and the cumulative premium payments of the settlors. Less certain is whether there would be sufficient funds to pay the settlors the “greater of” if the policy is terminated when one or both settlors are living. If the settlors’ cumulative outlay for premiums exceeds the cash value, the settlors will get the “greater of” only if the Trust holds assets other than the insurance policy. The Ruling specifically states that the payment to the settlors in this cir-

cumstance is made “to the extent the Trust has other assets.” Therefore, until the cash value is at least equal to the total premiums paid by the settlors, it is the settlors who are “at risk” and not the Trust.

4. The ruling states that “if some or all of the cash surrender value is used (either directly or indirectly through loans) to fund the Trust’s obligation to pay premiums, Settlor A and B will be treated as making a gift at that time. Therefore, as long as the policy is maintained, the settlors will be making gifts, either by making transfers to the Trust to fund the Trust’s obligation or because the Trust borrows on the policy to do so.

5. A problem with this kind of arrangement is that the term insurance costs increase significantly as the insureds grow older. Perhaps in this situation the insureds are in less than ideal health and the use of the standard rates minimizes the gift tax impact of maintaining the policy. Perhaps the game plan is for the Agreement to be terminated at or near the point at which the cash value is equal to the cumulative premium payments of the settlors. At that point, the settlors would, in essence, get the return of their cumulative premium payments without interest.

This ruling provides helpful guidance for anyone contemplating a private split-dollar insurance arrangement.

TRENDS AND TECHNIQUES

Significant Recent Trends and Innovations in Estate Planning

Tax Court Finds Ambiguity in Tax Clause and Applies State Apportionment Statute

If an estate plan does not have a provision apportioning taxes, or the provision for the apportionment of taxes is ambiguous, then state law applies. While this is not the preferred choice among tax practitioners, there are clearly a number of times when a state's statute comes into effect. *McCoy Est. v. Comr.*, T.C. Memo 2009-61 (3/19/09), is such a case.

The governing documents (a trust and a will) provided for specific bequests to others besides the wife, to be paid from the residuary estate. Different definitions of "residuary" could be interpreted under the documents. The different definitions of "residuary" created ambiguity over the tax clause, which sourced the payment of taxes from the "residue of the trust." No language specifically charged the payment of taxes to any particular share. The attorney who prepared the federal estate tax return reduced the specific bequests by their proportionate part of the estate taxes, under Utah's apportionment statute. Utah's apportionment statute apportions taxes to the source of the tax. As such, the property passing to the surviving spouse was not taxed. The IRS argued, however, that the marital share was the proper source of payment, and as such, additional estate taxes of approximately \$412,000 were assessed on audit.

The Tax Court determined that unless the will clearly states that estate taxes shall be apportioned differently than under the state law, the state apportionment statute applies. The Tax Court sided with the Estate that the will and revocable trust were unclear regarding the apportionment of tax. The IRS argued that the Tax Court should consider "extrinsic evidence" for the apportionment of taxes. The Tax Court, in a footnote, handled the evidentiary issues in an interesting way — noting that extrinsic evidence was not needed to interpret the will and trust in which the decedent clearly did not address taxes at all, thus leaving the matter to the apportionment statute. The Tax Court explained that what little extrinsic evidence existed pointed toward: (a) the decedent being dyslexic, (b) the decedent signing a draft of his restated trust

agreement without discussing it with his attorney, (c) the decedent never wanting to pay more taxes than absolutely necessary, and (d) the decedent never discussing the payment of taxes with his attorney or any one else. The Tax Court concluded that the decedent would have likely wanted taxes paid from the non-marital share, which was the source of payment in the original trust agreement.

The Tax Court held that the Utah apportionment statute must be applied to apportion taxes. Since Utah's apportionment statute provides that distributions creating the tax are the source that pay the tax, a marital distribution will not pay tax. The Tax Court concluded that the marital share bore no part of the tax created by the specific bequests. This resulted in more property for the surviving widow and less for the family members receiving specific bequests. The case highlights the care required to prepare an appropriate tax clause.

Ninth Circuit Affirms 5% Discount for Partial Interest in Art

In *Robert Grove Stone, et al. v. U.S.* (No. 07-17068, 3/24/09), the Ninth Circuit rejected the taxpayer's appeal from the decision of the district court for the Northern District of California. The district court had allowed a 5% fractional-interest discount in valuing the Estate's 50% interest in a 19-painting art collection.

In the lower court, the taxpayer had initially claimed a 44% discount, subsequently lowered to 36%. The Government conceded a 5% discount. In rejecting the taxpayer's appeal, the Ninth Circuit held that the taxpayer did not bear its burden of proof, citing the district court's focus on the taxpayer's appraiser's total lack of experience with the art market and reliance, instead, on discounts for real estate or limited partnership interests. This case illustrates the difficulty in establishing a significant discount for a fractional interest in art, given the lack of data.

IRS Recognizes Impact of Proposed Reformation to Correct Power of Appointment

In PLR 200910003, the IRS recognized and honored the intent of the grantor — to minimize estate and generation-skipping transfer (GST) taxes in the grantor's estate and the grantor's descendants' estates. The IRS recognized the grantor of a revocable trust was attempting to implement GST tax planning. The structure implemented is commonly used to remove assets from the estate tax system for as long as possible: the grantor's children receive shares of a non-exempt GST trust and the grantor's grandchildren receive shares of an exempt GST trust.

The attorney draftsman, after navigating most of the tax rapids successfully, failed to recognize that the power of appointment granted to a descendant of an exempt GST trust could be construed as a general power of appointment, rather than the likely intended special power of appointment. This issue is important because only with a special power of appointment would the assets be excluded from the beneficiary's estate, thereby minimizing estate taxes in the future. The problematic language was that the beneficiary could appoint the trust corpus to a descendant of the grantor. Since the beneficiary was also a descendant of the grantor, the primary beneficiary might be able to appoint to himself. Such an appointment, to himself, would cause the assets to be included and taxed in the beneficiary's estate.

The IRS agreed with the family that a court would reform the trust to correct the general power of appointment. The IRS cited and discussed *Comr. v. Bosch Est.*, 387 U.S. 456, 87 S. Ct. 1776, 18 L. Ed. 2d 886 (1967), which, in the IRS's view, requires that the IRS sit as the highest court in the state whose law controls the case, if such court has never ruled on the type of reformation issues involved. Doing so, the IRS determined that a local court would, and really should, allow the reformation to carry out the intent of the decedent. The family went to the IRS before going to the local court. Thus, the reformation-to-be was allowed in order for the trust to contain the cor-

rect special power of appointment as intended, and this decision means that the GST-tax-exempt status is prolonged for future generations.

Regulations if Decedent Was in Combat Zone or Federally Declared Disaster Zone

The Department of the Treasury has issued an amended regulation, effective January 15, 2009, for §7508A, Regs. §301.7508A-1. The amended regulation provides postponement relief — up to one year — for taxes, interest, and penalties in situations where the taxpayer is affected by a federally declared disaster or a terroristic or military action. As stated in the regulation, “[t]he postponement of the deadline of a tax-related act does not extend the due date for the act, but merely allows the IRS to disregard a time period of up to one year for performance of the act.” While the Examples given in the regulations focus on income taxes, the postponement relief should also be available to estates, to non-profits in federally declared disaster zones which need to pay unrelated business income taxes and file information returns, to individuals filing gift tax returns, and to trusts. Rather than relying on §7508A when sending in a return late, coordinate postponement relief with the Internal Revenue Service, before the due date, if possible.

*You Are Invited to Attend the May
Tax Management Advisory Board Meeting*

AGENDA:

Compensation Planning

MEMORANDA:

1. **“Kennedy v. Plan Administrator for DuPont Savings and Investment Plan: Beneficiary Determinations Under ERISA and the Plan Document Rule,”** by *Albert Feuer, Esq., Forest Hills, New York*
2. **Employee Benefits Issues in Bankruptcy,** by *Chad R. DeGroot, Esq., Bryan Cave LLP, St. Louis, Missouri*
3. **Fiduciary Duties in the Face of Troubled Economic Times,** by *John H. Wilson, Esq., and Anita Domalik Hogue, Esq., Buchanan Ingersoll & Rooney, PC, Pittsburgh, Pennsylvania*

**TO BE HELD
THURSDAY, MAY 21, 2009
WALDORF-ASTORIA HOTEL
BEEKMAN SUITE
NEW YORK, NY
MEETING: 5:30 PM
RECEPTION: 7:00 PM**

RSVP

Reception follows

Requests to attend will be honored and accommodations made within the limited capacity available and in the order in which they are received. Requests should specify the MAY COMPENSATION PLANNING MEETING and be addressed to BNA Tax & Accounting, 1801 S. Bell Street, Arlington, VA. 22202. For information about CPE or CLE credit hour awards, or to register, call Sandy Mackall at: (703) 341-5906.

NEW!

State Tax Essentials

State Tax Essentials: Quick Answers with Authority,
an annual overview of state business and individual taxes.

Providing summaries of the fundamental corporate and individual income tax issues for each state, **State Tax Essentials** is organized by state and by type of tax allowing you to quickly find answers to core questions.

Supporting the answers, you will find detailed citations to the relevant state tax statutes, regulations, and BNA State Tax Portfolios.

Written in plain English, **State Tax Essentials** also includes 27 state-by-state charts providing quick access to state tax rates, filing due dates, apportionment formulas, estate tax, sales and use tax information, and more.

Perfectly suited for both individuals and corporations, BNA's **State Tax Essentials** will help you easily find the multi-state tax information you need for your organization and clients.

**Order your copy of
State Tax Essentials
today at
tmstore.bna.com! Or call
Customer Service at
1-800-372-1033.**



BNA
Tax & Accounting

Showcase Your Knowledge!

Become a BNA Tax & Accounting Audioconference Speaker

BNA Tax & Accounting is looking for speakers and topics for our established audioconference program.

BNA Audioconferences are 60-90 minute sessions addressing current tax or accounting topics led by leading practitioners. They enjoy wide marketing by BNA to targeted audiences and are an excellent way to showcase your expertise and/or that of your firm or organization. Participants can earn CLE/CPE credit without leaving the office.

If you would like to become a speaker or have a topic that you would like to suggest, please contact Mark Carrington at mcarrington@bna.com or 703.341.5880.



BNA[®]
Tax & Accounting

